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SUBJECT: EU OFFICIALS VIEW OFFSETS AS POSSIBLE OBSTACLE TO
LINKING CARBON MARKETS

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¶1. (SBU) Summary: EU Commission officials, EU Parliament officials, NGOs, and industry are looking to the United States for development of a comprehensive cap and trade program that can benefit from the EU's experience with its own Emissions Trading Scheme (ETS). The use of carbon offsets in the system is of particular interest, because several European officials believe a transatlantic divergence on how offsets are applied could be the largest obstacle to linking systems in the future. Knowing that the United States will likely lead on the issue of climate change in talks leading up to Copenhagen in December, the EU is glad to share its experiences with offsets and the lessons it learned with ETS. Several key themes emerged in conversations:

-- most European officials anticipate some form of transatlantic carbon market in the future, and some in DG Environment consider this step to be more important possibly even than an agreement in Copenhagen;

-- the U.S. focus on the use of domestic agriculture and forestry offsets could prove to be a contentious issue when engaging with the EU and ETS; and

-- any offset program must be tapered and balanced; that is, the total number of offsets permitted must not represent too large a portion of the emissions cap, and this proportion should decrease over time. End Summary.

Linking the U.S. and EU Carbon Markets

¶2. (SBU) Damien Meadows, Deputy Head of Unit in DG Environment and one of the architects of the EU's Emissions Trading Scheme (ETS) Revision Directive, says that the European Union's main climate goal, possibly more important than an agreement in Copenhagen, is the creation of a global carbon market, beginning with an OECD-wide market and eventually expanding to include major emerging economies (see reftel). Recognizing this will take some time, Meadows thinks that the first step in the process should be to link ETS with a U.S. system expecting Japan and others to follow our lead. A key aspect of linking cap and trade systems is establishing consistency in the application of carbon offsets-emissions credits received normally through financial support of projects to reduce emissions, either domestically or in third countries.

¶3. (SBU) Meadows recommends a working group between implementing experts in DG Environment and the U.S. Environmental Protection Agency (EPA) to coordinate work on clean development mechanisms (CDMs) and sector-based crediting approaches to minimize future divergence. Tomas

Wyns, policy officer for the Climate Action Network, agrees that linking the two systems will be an important issue, but thinks that offsets present a challenge. Unlike the EU, which is pressing for a transatlantic market as soon as possible, Wyns does not think that linking needs to be rushed; it is more important and less expensive if the market works correctly.

14. (SBU) To link the U.S. and EU systems, Meadows believes that it will be necessary for U.S. and EU regulators to accept offsets permitted under the other's schemes. According to Meadows, the United States' focus on the use of domestic offsets should be modified to be more open to projects in developing countries while the EU should be more critical of the projects it accepts. Meadows recommends a flexible system that will allow for adjustments as the U.S. government discovers what works and what does not. Henrik Hasselknippe, global carbon market analyst for Point Carbon, noted that if there is heavy reliance on forestry or agricultural offsets in the U.S. system, neither of which the EU has accepted, the divergence will be difficult to overcome.

Domestic vs. International Offsets

15. (SBU) A key point highlighted by most officials is the difference in importance given to domestic offsets in U.S. draft legislation and the EU scheme. Meadows explained that unlike U.S. companies, European firms generally have not expressed interest in domestic offsets. Also, the EU has preferred to avoid uncertainty related to measuring domestic agricultural offsets, finding it cheaper to fund CDM projects

BRUSSELS 00000708 002 OF 003

in developing countries. Europeans have observed that U.S. farmers believe that agricultural offsets will benefit them, but Meadows cautions the United States to consider what might happen if the system turns around, and agriculture becomes a source rather than a sink, for example during a drought. Under this scenario, he questioned if farmers would then be required to pay into the system. The EU does not consider agricultural offsets to be cost-effective, given the technical and administrative burden required to make precise emissions measurements on small farms. However, Meadows recognizes that the United States has more industrial, large-scale farms where measurement is much easier and where accounting for methane emissions is currently under way. Despite this difference, Meadows suggests that the United States use policies already in place, such as linking current farming subsidies to better practices, instead of offering offsets.

Forestry Offsets

16. (SBU) There is no clear consensus in Europe as to how to address forestry. The EU has encountered a great deal of pressure to allow forestry credits to be used as offsets, which it has thus far resisted. Meadows points out the total number of available forestry credits dwarfs the ETS emissions cap, and because prices for forestry projects are cheap, which can lead to windfalls and speculation, both of which distort the market. Kavita Ahluwalia, Parliamentary Assistant to Member of European Parliament (MEP) Avril Doyle (Ire, EPP-ED), mentioned that MEP Doyle generally is opposed to forestry offsets. However, since deforestation is a big problem, she believes that perhaps a small number of credits in the U.S. system would not be an issue. By contrast, Tomas Wyns argued that the best method is to use a market-linked approach and invest auction money in reforestation, instead of providing credits.

What Europeans Want in a U.S. Cap and Trade System

¶17. (SBU) The EU will be looking to the United States for leadership on the climate issue. Although Meadows finds much in the current proposal by Congressmen Waxman and Markey laudable, he is concerned about the large number of offsets available, and thinks it would be better if the United States reduces the amount over time. Despite that criticism, Meadows said the Commission is taking some cues from the draft bill, explaining that as the EU moves toward ETS' Phase III beginning in 2013, it is considering discounting CDM projects on a 5:4 ratio, as proposed in the draft. Meadows also said that the EU might rule out what it considers to be "inappropriate" projects; for example, if China does not ratify a global climate agreement, it will not be granted any more CDM projects.

¶18. (SBU) In crafting a U.S. cap and trade system, Vicky Pollard of DG Environment warns that the United States cannot just use sticks to press companies into compliance. CDM projects will be seen as carrots and welcomed by businesses struggling to upgrade their equipment. However, Pollard cautioned that the United States and the EU must be careful in developing their respective CDM programs to be sure that developing countries do not take advantage of loopholes. For example, Pollard explained that Nigeria has slowed its domestic CO2 emissions legislation so it will be chosen for more CDM projects. She believes that such unintended consequences will be more likely if the United States does not craft legislation carefully.

¶19. (SBU) Several European officials argue that a successful offset program should be graduated and balanced, with more offset credits allowed at the beginning, slowly lowering the total amount allowed. Hasselknippe cautions against allowing too many credits at the beginning and cited the example where the EU has allowed too many offsets, driving down the carbon price. Though the draft Waxman-Markey bill limits the value of offsets by offering only an 80% credit for offsets purchased, Hasselknippe believes it would be easier to impose limits on the total number of allowed offsets and let the market set a price. He also believes that the Waxman-Markey proposal is too generous on offsets and those numbers will be impossible to find in the United States.

¶10. (SBU) Wyns stated that the United States must find a balance between what is feasible and what is necessary.

BRUSSELS 00000708 003 OF 003

"Offsets can play a valuable role" in striking this balance, by allowing for flexibility to achieve the cap target. Although there are lessons to learn from the EU experience, Wyns says the "best way to learn is by starting a system" because the economic and environmental realities in the United States are inherently different from those in Europe and will naturally achieve different results.

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